Lessons of Privatization

By Quenten Gilliam
I. Introduction

Susette Kelo greatly enjoyed the waterfront view of her home in New London, Connecticut, and to which she had made substantial improvements upon.\(^1\) Unfortunately for Ms. Kelo, her home stood between a massive development project which was estimated to create 1,000 new jobs, increase tax revenues and revitalize an economically downtrodden city.\(^2\) Kelo was unwilling to sell her home to NLDC (the private non-profit corporation in charge of the development), and brought an action to enjoin the sale because it violated the 5\(^{th}\) Amendment’s prohibition on taking of private property.\(^3\) The United States Supreme Court held that the taking of Ms. Kelo’s home was a valid exercise of eminent domain because the development plan would benefit ‘public use.’\(^4\)

A compensated taking of private property for public use by the Government mirrors the process of privatizing state-owned business enterprises. Taking from the private domain for public use is a property transfer that parallels selling publicly owned property to private entities in that both kinds of transfers arise out of macroeconomic decision-making, both require the forced taking of property (often against the will of the previous owner), and both involve a question of how much compensation is needed for a fair divestiture. Finally, both actions require

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\(^1\) Kelo v. City of New London, Conn., 545 U.S. 469, 475 (2005). Another Petitioner, Whilhelmina Dery, lived in her New London home for her entire life; her husband has shared the home with her for the last 60 years.

\(^2\) Id. at 472.

\(^3\) Id. at 495-96. The 5\(^{th}\) Amendment provides that “private property [shall not] be taken for public use, without just compensation.”

\(^4\) Id. at 490.
weighing the importance of pleasing a powerful or group or majority against protecting the
property rights of an inherently weaker group.\textsuperscript{5}

The loss felt by Ms. Kelo when the state condemned her home for economic development
is a hardship that all Americans can sympathize with. Losing a property interest in a state or
socially-owned enterprise due to privatization is equally frustrating, but perhaps more foreign to
westerners. Recognizing the challenges presented by privatization, the author asks how a country
can most effectively produce a smooth transition to a private-sector economy. To answer this
question, the author identifies four goals of privatization: (1) to create a more efficient, profit-
producing nation (2) to encourage foreign investors to contribute capital to newly privatized
entities (3) to implement a system in which claims by prior owners and creditors against the
former entity can be asserted and addressed, and (4) to balance the need for encouraging
investment in the new entity, while maintaining a system of addressing claims against the old
entity. A country that recognizes these goals as top priorities in privatization will ensure greater
success in the transition to a privatized economy. This strategy allows for economic
improvement through encouraging foreign capital and savoir faire; but it also provides a
mechanism for people like Ms. Kelo to express harms and losses they have suffered in the
process.

\textbf{II. Broad Aspects of Change}

Privatization is a socio-economic transformation of socialist-centralist economies by
means of transferring state assets and enterprises to the private sector, resulting in fundamental

\textsuperscript{5} The powerful group consists of wealthy investors in the case of privatization. It consists of the government and the general
public in the Takings Clause cases. The weaker group in a Takings Clause consists of a minority of individual landowners or, in
the case of privatization, parties with prior ownership claims to a state-owned entity.
changes in the ownership relationships in production and distribution of wealth.\(^6\) A country choosing to transition away from a centrally planned economy has discovered a fundamental flaw and has chosen to self-correct through economic transformation.\(^7\) Where a community has recognized a need for change, however, there remains a danger that it will generate a negative reaction, especially when change is mandated from above.\(^8\) Both an employee with a back-wages claim against a bankrupt business undergoing privatization and a homeowner like Susette Kelo, will understandably be resistant to changes affecting them.

A common interest approach\(^9\) can help combat the pitfalls associated with exogenously mandated change.\(^10\) Even when change is not forced from the top down, too much of it too quickly can result in a reactionary backlash.\(^11\) To prevent a movement against change, transition must come gradually, and those bringing about change must provide the voices of dissent with an opportunity to be heard.\(^12\) Finally, change is more likely to be accepted if reformers demonstrate that the benefits of prospective change exceed the benefits of the status quo in a meaningful

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\(^7\) According to well-known psychologist James Prochaska, this internal contemplation is the first stage of change. James O. Prochaska & Carlo C. DiClemente, Transtheoretical Therapy: Toward a More Integrative Model of Change, 19 Psychotherapy: Theory Res. & Prac. 276, 282-85 (1982) (identifying four stages of the process of change: contemplation, determination, action, and maintenance as well as the preceding and following stages of precontemplation and termination).

\(^8\) Interview with Ellen Mitchell, Dean of Psychology, Illinois Institute of Technology in Chicago, Ill. (Sept. 22, 2011).

\(^9\) Id. A common interest approach focuses on negotiation among groups.

\(^10\) Exogenously mandated change is change brought enforced through Government, such as the Emancipation Proclamation in 1863. Similarly, in Kelo, major resistance to the City’s development plan came from individuals whom the plan negatively affected.

\(^11\) Id.

\(^12\) See id.
way.\textsuperscript{13} Privatization, for example, presents significant opportunities to increase the overall wealth of a nation.\textsuperscript{14} Susette Kelo may be unhappy with how the transition has affected her individually, but she will be more amenable to change if she has a means to express her grievances and if she can appreciate the common good arising out of her loss.\textsuperscript{15}

III. General Economics Background

\textit{a. Macroeconomic Policy and the Transition to Capitalism}

Macroeconomic theory studies the performance and decision-making of the aggregate, rather than the individual.\textsuperscript{16} Specifically, it concerns the analysis of general price, national output and total employment.\textsuperscript{17} Macroeconomics is used to develop governmental policy and business strategy, including the extent of a government’s role in the national economy. An election to transition from a centrally-planned economy to a market-based economy reflects a political consensus that moving away from a state-run economy will bring about greater stability, encourage growth and increase output. Thus, privatization is a macroeconomic choice to reduce government involvement in the economy, with the goal of increasing overall wealth.

\textsuperscript{13} \textit{Id.}

\textsuperscript{14} Michael J. Trebilcock and Edward M. Iacobucci \textit{Privatization and Accountability} 116 Harv. L. Rev. 1422, 1422 (2003) (demonstrating that private entities are superior to governmental organizations in pursuing profit because they are organized in a competitive setting).

\textsuperscript{15} Ironically, after Ms. Kelo’s home was razed, Pfizer pulled out of the development plan and the land is in complete disuse. But, the point is that assuming public good will arise, Ms. Kelo will at least have some consolation in knowing that losing her home helped improve the overall welfare of the City.


\textsuperscript{17} \textit{Id.}
b. Microeconomic Policy to Encourage Investment

Microeconomics is the study of how individual households and firms make decisions to allocate limited resources and how these decisions affect supply and demand.\(^\text{18}\) A major goal in analyzing the allocation of resources is to look at the set of alternative uses of wealth and to understand what generates the greatest profit. The value of a foregone allocation, that is, one which is not chosen, is called the opportunity cost.\(^\text{19}\) In analyzing resource allocation, an actor will weigh the expected value of one allocation option against the opportunity costs associated with other allocations.\(^\text{20}\) Expected value takes risk into account by multiplying a projection of returns by the probability that they will materialize.\(^\text{21}\)

i. Allocating Resources

On a microeconomic level, an individual actor uses opportunity cost determine how best to allocate her resources. For example, a farmer can use her land in several different ways: she can rent it, she can farm it or she can use it to feed her cattle. If the farmer is able to determine the profit gained in each of these ways, she is able to compare the value derived from renting the land with the opportunity costs of using it to farm or using it for cattle-feed. If the value of

\(^{18}\) Greenwald, at 296.

\(^{19}\) Id at 331.

\(^{20}\) See id. at 331. Allocating resources can be done on a macro-level, as well. On an aggregate level, a government may have to choose between different allocations of resources in times of scarcity by weighing the value of resources used to produce one good, against the value of using the resource to produce another. For example, in wartime, a nation must choose between manufacturing weapons or automobiles. The opportunity cost of producing guns is the value of producing the automobiles because the resources must be allocated to one or the other. Similarly, a society electing to privatize has determined that the benefits of a centrally-planned economy are less than the benefits of undergoing privatization.

renting is higher than opportunity cost of farming, then she will allocate her resources toward renting the land.\textsuperscript{22}

Successful privatization requires private investment.\textsuperscript{23} But no investor will allocate his resources without assurance that the allocation is the best use of his capital. Thus, a firm undergoing privatization must convince private actors that investing capital into the formerly state-owned entity is the most viable allocation of their resources.\textsuperscript{24}

IV. What are the goals of Privatization?

The goals of privatization are to improve overall efficiency, to encourage investment, to provide a mechanism for adjudicating claims by prior owners and creditors against the former entity and, most importantly, to balance the need for providing a system of addressing claims with the need for protecting new investors from old liabilities.

\textit{a. Improving efficiency}

Improving efficiency is a major goal of privatization because one of the main justifications for transformation was the need to escape the manifest inefficiency in public-sector economies. Certain disciplinary factors that are present in a private context, but lacking in the public, contribute to increased private-sector efficiency.\textsuperscript{25} The primary disciplinary factors are

\textsuperscript{22} Interview with Henry Perritt. Professor of Law and Director of the Graduate Program in Financial Services Law, IIT Chicago-Kent College of Law in Chicago, Ill. (Sept. 9, 2011).

\textsuperscript{23} See infra pp. 16-23.


\textsuperscript{25} Michael J. Trebilcock & Edward M. Iacobucci \textit{Privatization and Accountability} 116 Harv. L. Rev. 1422, 1422 (2003)
profit motive and competition. Because private firms organize themselves to maximize profits, and must compete with other firms to survive, efficient production is of paramount importance.26

This section begins with a discussion of the inefficiency inherent in socialism, followed by a discussion of how profit motive and competition in capitalist economies improves efficiency. The section finishes by addressing some counter-points to the goal of efficiency.

i. Recognizing the need for change

The first step in effecting change is problem identification, the recognition that a problem exists.27 The economic overhaul inherent in privatization demands acknowledgement that the existing system is flawed. Socialist decision-makers, for example, had to face the fact that enterprises in centralized economies were simply not producing as efficiently as their counterparts in capitalist economies. Socialist countries reported lower scores on indexes indicating economic efficiency such as per capita consumption and labor productivity, as well as in gross national product values.28 Soviet-type nations were over-dependent on heavy industry versus modern service industry and there was a lack of real business initiative due to general

26 Trebilcock at 1427-28.

27 James O. Prochaska & Carlo C. DiClemente, Supra. A useful analogy is quitting smoking. The recognition of a necessity to quit is a leap toward quitting itself. A smoker has to acknowledge that her habit is presently taking a real toll on her health, which will only get worse as time goes by. Problem identification does not arise out of some remote notion of dysfunction; it must be grounded in dissatisfaction motivating change.27 Thus, a smoker must realize that her habit could result in death; similarly, a nation’s decision to privatize must be the result of universal recognition that the former system was unworkable.

28 Paul B. Stephan, III Toward a Positive Theory of Privatization – Lessons from Soviet-type Economies 16 Int’l Rev. L. & Econ. 173, ___ (1996). The gap between the economic performance of Soviet-type countries and the economic performance of newly industrialized capitalist countries like Japan, Korea and Taiwan was widening significantly in the early nineties. Soviet-type countries also received comparatively lower scores in quality of life indices such as life expectancy and environmental degradation.
disfavoring of innovation and the illegality of buying and selling for profit.\textsuperscript{29} Shadow economies mushroomed.\textsuperscript{30} State-owned property was characterized by economic stagnation and inflexibility due to bureaucratic apparatuses.\textsuperscript{31} Socially-owned property, most common in the former Yugoslavia under Tito, was difficult to manage because of its ambiguous ownership.\textsuperscript{32} Given the inefficient state of the economy in these Soviet-style states, most people recognized a need to increase efficiency in production. Privatization increases efficiency because private firms are motivated by profit and competition.

ii. Profit Motive

Efficiency is maximized through privatization because private firms are organized to maximize profits.\textsuperscript{33} Private firms are typically more successful than the state in pursuing profit because owners are residual claimants on the profit generated.\textsuperscript{34} Residual claimants are the people who receive the net income that the company makes; they are highly driven to increase profits because doing so directly increases their own wealth. Because private companies are driven to profit by residual claimants, they are more likely to be efficient in maximizing gains

\textsuperscript{29} PAUL J.J. WELFENS AND PIOTR JASINSKI, PRIVATIZATION AND FOREIGN DIRECT INVESTMENT IN TRANSFORMING ECONOMIES 16 (Dartmouth Publishing Co. Ltd 1994); Andrei A. Baev Civil Law and Transformation of State Property in Post-Socialist Economies:Alternativesto Privatization, 12 UCLA Pac. Basin L.J. 131, ___ (1993) (discussing the problems with centrally-planned economies. For example, vegetable warehouses were filled with rotten food to avoid surpassing state mandated food production quotas. In Russia, the state controlled how much sugar and living space families could have).

\textsuperscript{30} WELFENS,

\textsuperscript{31} Id.

\textsuperscript{32} Simon Chesterman, Book Review, 102 Am. J. Int’l L. 405 (2008) (reviewing DOMINIK ZAUM, THE SOVEREIGNTY PARADOX: THE NORMS AND POLITICS OF INTERNATIONAL STATEBUILDING 2007) (the status of territory was in limbo. No one knew who owned the property in these socially-owned companies: was it the state, the province, the municipality, or the workers?)

\textsuperscript{33} Id.

\textsuperscript{34} Trebilcock & Iacobucci, at 1424.
and cutting down on costs.\textsuperscript{35} Government enterprises, on the other hand, are less successful in pursuing profits, because allocating the residual claim to the Government means that every citizen has an equally minute interest in the entity’s profits.\textsuperscript{36} If the state is the residual claimant, then the interest-holders will rationally be more apathetic to the efficiency of the enterprise than they would be if it were a private company, where the interest holder’s stake is far more palpable.\textsuperscript{37}

iii. Competition

Competition among actors is another source of efficiency in private-sector economies. In contrast, competitive product markets do not discipline managers in the public sector as well as they do in a private setting, managers depend on capital for their corporations to survive.\textsuperscript{38} Competitive discipline requires a private firm not to waste resources because when investment is no longer forthcoming and retained earnings disappear, the private corporation is forced to wind up.\textsuperscript{39} In contrast, public enterprises do not face such dire consequences flowing from a lack of capital.\textsuperscript{40} They have access to capital through alternative sources, such as government taxation.\textsuperscript{41} Due a heightened risk of failure, private corporations are generally better able to provide goods

\textsuperscript{35} Id. at 1424-26.

\textsuperscript{36} Id. at 1426.

\textsuperscript{37} See id.

\textsuperscript{38} Trebilcock & Iacobucci, \textit{supra} at 1428.

\textsuperscript{39} Id.

\textsuperscript{40} Id.

\textsuperscript{41} Id. Governments will often guarantee the debts of state-owned enterprises (SOEs), allowing these entities access to alternative sources of capital as well.
and services at a lower cost and have greater incentive to innovate. Thus, competition makes full private property ownership the most efficient allocation of resources.

iv. Possible Drawbacks to the Focus on Efficiency

Social costs are sometimes associated with the efficiency-maximization inherent in privatization. While considerations of social welfare do not directly interfere with the goal of improving efficiency, they challenge the very notion that efficiency should be a paramount goal. When private parties contract to trade, presumably they do so because it makes both parties better off. Such trade may not increase the social welfare in cases where the transaction affects third parties.

Additionally, privatization causes serious problems for considerable strata of the population. Reduced output often results from privatization because one of the first changes implemented in a newly privatized entity is to curb unprofitable overproduction. Reduced output leads to reduced income and falling wages because there is less need for workers and production. Shortages of family wealth and income are made worse by heightened

\[\text{\textsuperscript{42 Id.}}\]
\[\text{\textsuperscript{43 Id.}}\]
\[\text{\textsuperscript{44 Id.}}\]
\[\text{\textsuperscript{45 Id. For example, if a person contracts with a trumpeter to wake her up at four in the morning, the agreement may put both parties in a better position, but decreases overall social welfare by harming the neighbors.}}\]
\[\text{\textsuperscript{46 WELFENS, at 19-21.}}\]
\[\text{\textsuperscript{47 WELFENS, In a command economy, production does not match consumption. As a country moves toward a market economy, the gap between these rates lessens.}}\]
\[\text{\textsuperscript{48 WELFENS}}\]
unemployment. Moreover, in a socialist system, the state-owned enterprises (SOEs) provide public services. In privatization, the services are cut to increase profits, leaving the government to provide them. Governments may not be prepared for this responsibility, and may not have well-enforced taxation practices to fund the social services. Reduced output, falling wages, unemployment and a decrease in social services result in great economic hardship to the county’s poorest. Economic hardships to individuals undergoing privatization are often worsened by perceived windfalls gained by well-connected locals and foreigners throughout the process. 

Additionally, there is a lack of accountability problem when the private sector takes over publicly provided goods and services because private actors are not subject to traditional state constraints and transparencies. These tribulations raise questions about the emphasis placed on efficiency in market-based economies vis-à-vis centrally planned economies. Someone like Ms. Kelo may understand that her loss is a pre-requisite to overall improvement; but that does not mean she will support it. Convincing the population that maximizing efficiency is the best choice for the country is thus a major challenge to implementing economic transition.

49 WELFENS, Unemployment takes two hits. Jobs are reduced in discontinuing an unprofitable line of business, and in cutting costs associated with profitable ones.

50 WELFENS, at 3-4.


52 WELFENS,.


54 Nestor M. Davidson, supra at 274. (Author’s note: although state constraints and transparencies are more prevalent in the West, this notion still poses a challenge to privatization in the Post-communist bloc because of reduced emphasis on social welfare).
Although there are some downsides to the goal of efficiency, one can reasonably surmise that transferring property rights from the public sector to the private will be positive for all as economic efficiency and eventually, social welfare increase.\textsuperscript{55} In competitive markets, an individual can be made better without making someone else worse off.\textsuperscript{56} Under Pareto’s theory of optimal efficiency, resources can be reallocated by a private firm such that their self-motivated actions serve the public interest as well.\textsuperscript{57} For example, competitive firms acting in self-interest will drive prices down to marginal cost, thereby maximizing society’s gains from trade in goods and services.\textsuperscript{58} The aim of efficiency, therefore, does not necessarily eviscerate public good; in fact, greater efficiency can be concurrent to a greater good.

\textbf{b. To Encourage Investment}

Privatization is the transfer of state assets and state enterprises to the private sector by sale.\textsuperscript{59} Because every sale must have buyers, and because buyers must have capital to spend, capital investment is paramount in the privatization process. Additionally, capital improves the productivity of socialist enterprises through innovation and new business strategies.\textsuperscript{60} Investors are willing to expend this critical capital if they are convinced that doing so will yield a profit.

\textsuperscript{55} \textsc{Welfens}, at xiii.

\textsuperscript{56} \textsc{Douglas Mair and Anne G. Miller}, \textit{A Modern Guide to Economic Thought} (Edward Elgar Publishing 1991) 87-90.

\textsuperscript{57} Trebilcock et al. at 1430. According to Vilfredo Pareto, an early twentieth century economist, if the benefits of change exceed the benefits of the status quo, everyone must be made better off without anyone being made worse off.

\textsuperscript{58} \textit{Id.} Another example is when economic policy demands that a monopoly cease to exist. This situation appears to be beneficial for the public while making the monopoly worse-off. However, the loss to the monopolist will be offset by the gain in efficiency resulting from new competition. Thus, the policy is Pareto-efficient.

\textsuperscript{59} Baev, at 150.

Once investors have a stake in an enterprise, they will make every effort to ensure that the enterprise is functioning efficiently and profitably. A major goal, therefore, of privatization is to encourage investment into former collectively-owned enterprises to overcome capital scarcity, accelerate innovation and entrepreneurialism, and to increase profitability. Given the importance of investment to privatization, this section addresses where investment comes from and how to obtain it. Investment comes from foreign and local individuals and government treasuries. To access this capital, a privatizing entity must demonstrate that investment in their business is the best allocation of an investor’s resources.

i. Where does Investment Come From?

Investment is generated from foreign and local government surplus, from savings held by international and local private individuals, or from international business entities. Foreign direct investment (FDI) is a more viable possibility than local investment, since former communist countries are often low on domestic savings. FDI comes from either foreign governments, or from private foreign investors. The Marshall Plan of 1948 to 1952 is regarded as the most successful strategy for economic reconstruction and can be used as a model for seeking investment from the West. China and the oil-rich nations have a surplus of dollars and euros flowing from trade deficits owed by the US and other developed nations. Savings do these countries no good without investment; thus, they can be more easily convinced to invest in privatizing nations.

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61 Azubuike, at 73.

62 Perritt, at 278; Baev, supra at 147.

63 Graciana del Castillo, Economic Reconstruction of War-Torn Countries: the Role of International Financial Institutions 38 Seton Hall L. Rev. 1265 (2008)
ii. Convincing investors to invest

A firm, undergoing privatization and in search of investment capital, must convince investors that purchasing an interest in the firm is the best way for an investor to allocate his resources. But, how does one prove to an investor that it is better to put his money in a Balkan manufactory than in a lucrative website such as Yahoo, when the risk involved in the former appears to exceed the risk in the latter? To diminish perceived risk of investing in a privatizing entity, SOEs must increase the possibility for gain. The expected value of one allocation of resources takes risk into consideration by multiplying the return on an investment by the probability that it will occur.\(^{64}\) Thus to, encourage investment, a firm must increase the probability that investment will yield a return. This can be achieved through a persuasive business model and stronger business climate.

First, it is necessary to have an innovative business model that emphasizes to investors that with a little bit of money and the right management, the investment has the potential to yield very high profits. In other words, while there may be a greater chance of risk, there is an equally greater chance of yielding high profit.\(^{65}\) Second, an adequate business climate must be in place before investment in a privatized entity is possible.\(^{66}\) Because the socialist model did not emphasize goals like efficiency and profitability, the services built-in to assist in obtaining these goals do not exists in post-communist settings. Former communist countries lack consulting firms, banks or management experienced with capitalism, which are necessary to strengthen the burgeoning

\(^{64}\) See Robert J. Rhee, at 525.

\(^{65}\) See WELFENS, at 34.

business climate during transition.\textsuperscript{67} Such financial intermediaries encourage investment in privatizing countries by aiding in the evaluation of risk and allocation of resources.\textsuperscript{68} Additionally, lawyers are needed to help in the formation of businesses and to provide transactional services.\textsuperscript{69} Lending and savings institutions are necessary to foster the growth of domestic capital to be used for investment.\textsuperscript{70} A debit and credit card system is also pivotal in facilitating monetary transactions.\textsuperscript{71} With these developments in place, foreigners will find the decision to invest in SOEs much more justifiable. As demonstrated in the hypothetical below, savvy business model and an improved business climate, will increase the probability of generating a return on investment, making investors less hesitant to purchase interests in privatizing SOEs.

\textbf{iii. Hypothetical to illustrate an investor's decision to invest}

\textit{Ali, a wealthy entrepreneur from Dubai, is looking for ways to diversify his investment portfolio.} \textit{He has already invested in an American sports team, a Russian up-start and he is now deciding between Plevic, a car-parts manufacturer in Kosovo versus Nesto, A Swiss chocolate company.} \textit{He is going to use microeconomic principles to determine which investment is the best allocation of his wealth. His consideration will hinge on potential for short term and long term profit and degree of risk in each option.}

\textsuperscript{67} \textit{Id.} at 299-302.

\textsuperscript{68} \textit{Id.}

\textsuperscript{69} \textit{Id.} at 301-2.

\textsuperscript{70} \textit{Id.} at 279-80.

\textsuperscript{71} \textit{Id at} 300.
The potential for short term and long term profit suggests that Ali should invest in Plevic, because he can invest at a comparatively lower price than Nesto, and he has the potential to receive a return from his investment which is a multiple of his initial investment. Whereas, with Nesto, it is costly to invest and his return, while more guaranteed, does not have potential to be as great. Nesto is likely to generate some profits, but if Plevic is a success, he can make much more money.

It will be cheap to invest in Plevic, because it is perceived as worthless. Also, Plevic has devised a business plan to save investors some money by selling old, useless industrial materials to scrap metal yards. Ali will appreciate the effort made by Plevic to marshal whatever assets remain into cash. Ali will also look to see what business-assisting intermediaries are available in Kosovo to help the firm get on its feet. The enterprise may start off slowly, but in the long term, investment is likely to pay off. As the company gets going and begins to make money, Ali will benefit because he has been there since the start, and entered in at a low cost. When the company establishes itself as a well-managed and successful enterprise, his profit will continue to soar.

Clearly, there is more risk in investing in Plevic, because the enterprise has just recently privatized, the institutions in Kosovo are weak and it is hard to predict what kind of success this entity will have. In fact, Ali risks losing everything if Plevic fails. In contrast, Nesto is a firmly established company where profits have risen slowly but steadily for many years, although due to recent economic downturn, the company has had some troubles. With respect to this consideration, Nesto wins out. However, because Ali is very wealthy, young and has a
diversified portfolio of predictable investments already, he is more willing to invest in a volatile industry so this consideration carries less weight.

The hypothetical illustrates that a major concern of investors is the profitability of investing in a privatizing entity. Additionally, investors will want to know whether they will be saddled with liabilities from the former entity.

c. To Implement a Due Process Mechanism for Compensating Former Owners and Addressing Creditor’s Claims.

To encourage much-needed investment in state-owned property, privatizing entities will have to address investor concerns over being saddled with claims against the former entity. A nation undergoing privatization must design and implement a system of shielding investors from potential leftover liabilities by establishing a means for prior owners and other creditors to file claims against the SOE.\(^{72}\) This will not only encourage investment by giving investors protection against liabilities from the old entity, it will also give claimants a sense of justice and accountability during the transfer of collective assets to the private sector. To draw a parallel to the Takings Clause case, Susette Kelo may not have wanted her property bulldozed; but at least she had a judicial means to express her grievance.

An agency entrusted to adjudicate claims brought by aggrieved parties against old entities is pivotal to implement this goal.\(^{73}\) In the former-Yugoslav nation of Kosovo, the independent

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\(^{72}\) See Perritt, at 288; see also Ed Pauker, *Procedure and Privatization in Kosovo: A Critique and Assessment of the Special Chambers* 2-3 (2007).

\(^{73}\) See Baev, at 147.
body tasked with privatizing socially-owned entities was the Kosovo Trust Agency (KTA). Socially-owned entities, common under Tito’s Yugoslavia, have many of the economic difficulties associated with privatization that SOEs have, coupled with the additional issues of employee and community ownership. The KTA’s aim is to free up as much money as possible by selling the assets of businesses to private investors and to resolve disputes arising out of this process. Before any discussion of agency functions is possible, it is first necessary to look at some examples of claims against a hypothetical entity undergoing privatization, to illustrate both the complexity of these claims and how they deter investment.

i. A Hypothetical Socially-Owned Entity

Plevic manufactures shock absorbers. Before privatization, the former employees held a 50% interest in the company, and current employees held the other 50% interest. The company had 100 employees at its peak in 1967. The management is intact and competent; the current workforce is willing to return to fulltime employment. At its peak, Plevic was the pride of Theranda a community in Kosovo. Plevic had state of the art technology and employed almost the entire area. The company has been out of business since 1999 when Yugo, the car company who bought Plevic’s shock absorbers ceased to exist. The supply chains Plevic once controlled are all closed now due to strife in Serbia. Despite these challenges, the Kosovar entity promises to sell to major car companies again worldwide. The entity has assets, including a large number of young people who are willing and able to work and international connections arising out of

74 Id.

75 Id. The Special Chambers of the Supreme Court is the adjudicative branch of the KTA which is charged with addressing claims arising out of privatization.
the diaspora, which can translate into more business connections. The balance sheet below indicates the assets and liabilities of Plevic, using Western accounting practices. Many of the liabilities indicate possible claims against the entity, which will need to be addressed so as to afford claimant their due process.

### ii. Plevic’s Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Stated Value</th>
<th>Liabilities</th>
<th>Stated Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>5k</td>
<td>Supplier of cylinders</td>
<td>8k</td>
</tr>
<tr>
<td>Building/factory</td>
<td>5k</td>
<td>Liquor Provider</td>
<td>8k</td>
</tr>
<tr>
<td>Inventory</td>
<td>2.5k</td>
<td>Bank loans</td>
<td>20k</td>
</tr>
<tr>
<td>Cash on Hand</td>
<td>2.5k</td>
<td>Former employee claims</td>
<td>10k</td>
</tr>
<tr>
<td>Contract with Libya</td>
<td>30k</td>
<td>Current employee claims</td>
<td>10k</td>
</tr>
<tr>
<td>Contract with Yugo</td>
<td>20k</td>
<td>Libyan contract performance</td>
<td>25k</td>
</tr>
<tr>
<td>Serbian bonds</td>
<td>5k</td>
<td>Serbian bonds</td>
<td>20k</td>
</tr>
<tr>
<td>Equipment</td>
<td>8k</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>78k</td>
<td></td>
<td>101k</td>
</tr>
</tbody>
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### iii. Analysis of Balance Sheet

The plant is insolvent by $23,000. The entity needs to demonstrate to investors that Plevic is a profitable allocation of their money by designing a viable business model to attract private investors. One challenge is that the balance sheet does not reflect the actual debt of the company. Even under Western accounting, the land and the building may be worth far more than their stated value, since real property appreciates over time. On the other hand, the majority of

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76 Id.
the assets are worth nothing because the accounts receivable will never be received. The equipment is eroding, the inventory is old and worth very little. The Libyan government and the Milosevic relatives are not likely to pay their debts owed to Plevic. The employee claims and unperformed contract obligations must additionally be addressed.\textsuperscript{77}

\textsuperscript{77} A closer look at Employee and Creditor Claims

1. Claimant is a current employee of Plevic

The claimant is a current employee of Plevic, Ebdo, who is owed back wages. Ebdo is willing to work in the new enterprise, when it re-opens. This claimant is not a priority in terms of debt payment under US bankruptcy law. He is thus probably willing to stay his claims until the business gets going again, knowing he has no choice if he wants to keep his job. If the new business fails, it is doubtful he will ever see his work wages. However, if the business succeeds, he will be repaid once the funds to do so are available. Moreover, if Plevic offered him a small amount of stock in the company in return for staying his claims, he will continue to profit from his earlier claim.

2. Claimant is a former employee of Plevic

Arben is a retired employee with a vaguely defined ownership claim to the land and an equally vague interest in the entity. The uncertainty of title arises from the fact that he and other former employees and member of the town owned Plevic as a class, under Tito’s version of socialism, which involved Government-mandated social ownership. The agency needs to first define Arben’s class. Although he is a former employee, he is also a member of the municipality and an important member of the community. Which characteristic entitles Arben to a piece of Plevic? Is it his membership in the town or the community, or his employment? Since Tito’s model for socialism reflected both kinds of ownership, this is no easy question to answer.

3. Bank lender

In this hypo, the creditor is a Yugoslav bank, Bankovia, who has loaned Plevic 20k to build a new annex to the factory in 2000. The annex was near completion, when the money ran out. Since then, the factory has been closed. The bank wants to see their loan paid back with interest as soon as possible, because they do not have an optimistic attitude about Plevic’s success. This bank is a priority creditor according to US law. Secured creditors get less interest in exchange for making less risky loans, and so they will be one of the first claimants to be addressed by Plevic.\textsuperscript{5}

4. Future unknown claimants

Plevic will need to at some point put an end to claims from creditors. They can give notice in publications of a sunset provision on the opportunity for acting on creditor claims regarding Plevic. At that point, all claims are barred. Before this point, however, some kind of system needs to be in place to protect new investors while also giving claimants the chance to seek payments owed to them and/or enforcement of agreements. Thus, some money needs to leftover for these claims.
iv. How an agency would address these claims

An agency empowered to address the claims must hold the assets of the entity in trust for claimants, meanwhile it must fully shield the investors themselves from any of these liabilities.\textsuperscript{78} The KTA, for example, was given authority to administer the privatization of the enterprises in Kosovo, with the goal of freeing up as much money as possible for investment in the Kosovo economy.\textsuperscript{79} The KTA privatizes in two ways, depending on the size and success of the entity.\textsuperscript{80} The regular spin-off plan is for small and medium entities and special spin-offs involve the larger, more well-known entities in Kosovo.\textsuperscript{81} Once the KTA has decided that privatization is viable for a number of countries, the agency publishes a list for bidders.\textsuperscript{82} The only difference in special spin-offs, is that the bids must be higher and the bidders must demonstrate more business acumen.\textsuperscript{83} The highest bids are accepted, and the proceeds of both types of spin-off are placed in trust for claimants.\textsuperscript{84}

In order to protect interested investors from the claims of suppliers, employees, and state as well as municipal governments, there must be a plan for handling those claims. A restructuring plan can address creditor’s claims and promote investment by effectively creating a

\textsuperscript{78} Perritt at 288-89.

\textsuperscript{79} Pauker, at 3.

\textsuperscript{80} Id. at 3-4.

\textsuperscript{81} Id.

\textsuperscript{82} Id.

\textsuperscript{83} Id.

\textsuperscript{84} Id.
A restructuring will also legitimize the privatization process in the eyes of the people who are most affected by it, the people. In a system which respects rule of law, creditors and claimants are entitled to reimbursement for relinquishing ownership and must be afforded a means through which to assert their claims. Moreover, investors are potential future creditors, too; they want to see how they might be treated if the business venture fails.

Convincing investors to invest in an SOE is not the only microeconomic calculation involved. A major function of the agency is to decide whether to liquidate or to reorganize a bankrupt entity. The decision to sink or swim is not an easy microeconomic election. Just because a company will improve economic efficiency by transferring property rights does not a fortiori guarantee that the cost of reorganization is more optimal than any other choice. In appropriate cases, an entity may be liquidated, creating the opportunity for investors to obtain the assets more cheaply. Often, reorganization is attempted with the looming specter of liquidation,

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85 Id.
86 See Phillips at 455-56.
88 “Sinking” is equivalent to liquidation; “swimming” is reorganization.
89 Welfens at 92.
if negotiations fail.\textsuperscript{91} Reorganization under Chapter 11 of the United States Code provides a good model for this process.\textsuperscript{92}

\textbf{v. Chapter 11 Bankruptcy as a model for the business enterprise}

Chapter 11 Bankruptcy Reorganization is a final attempt at restructuring an entity on the brink of failure.\textsuperscript{93} When an entity is unable to pay debts owed to creditors, Chapter 11 bankruptcy aims to rehabilitate and continue the business while following debt repayment plans.\textsuperscript{94} In this case, the debtor retains ownership of the assets and continues to run the daily operations of the business;\textsuperscript{95} meanwhile, a committee of interested parties is formed to work out a plan for repayment.\textsuperscript{96} Although US Bankruptcy law does not govern privatizing nations, it provides a simple, useful model for countries to emulate during their transitory period.

Using its administrative authority, an agency has the power to evaluate and adjudicate claims to ownership. Throughout this process, there is always a concern that assets will be “given away” to foreign investors. To prevent local resentment, it may be important to leave an interest for domestic investors.\textsuperscript{97} Due to the delicate nature of the privatization, the agency

\textsuperscript{91} \textit{WARREN supra} at 365.

\textsuperscript{92} \textit{See} Phillips, at 477; \textit{WARREN} at 389. (Reorganization has several advantages to Chapter 7 Liquidation. It keeps the business going which means the managers and employees do not lose their jobs.

\textsuperscript{93} \textit{See \textit{WARREN supra} at 389.}

\textsuperscript{94} 11 U.S.C. §§ 1121-1129.

\textsuperscript{95} \textit{Id.}

\textsuperscript{96} \textit{See id.}

\textsuperscript{97} \textit{See Perrit, Supra} at 291.
granted with authority must be a trusted to successfully balance the need for capital against the need for fairness to claimants.\(^\text{98}\)

\[d. \quad \text{To balance the inherent conflict between the need to shield new private investors from liability and ensuring fairness to prior owners and creditors} \]

The fourth and final goal of privatization is to balance the inherent conflict between encouraging private investment in new entities, while at the same time guaranteeing that claims against the old entity are heard and addressed meaningfully. The need for private investors is accompanied by a need to compensate prior collective owners for their divestiture. Just as private investment is inherent in the transition to a capitalist based economy, there is an inherent tension between the need for private investment and accounting for prior ownership and repaying debt. To encourage investment and ensure due process in property transfers, the formerly state-owned entities need to be restructured. This process can resemble a Chapter 11 Reorganization bankruptcy proceeding, or a Chapter 7 Liquidation bankruptcy proceeding if there is no intention of maintaining the enterprise.\(^\text{99}\) This section begins with the Plevic hypothetical to exemplify the challenges in striking the proper balance between the competing interests of investors and claimants. The cases of Conrail and \textit{Blanchette v. Connecticut. General Insurance Corporation} illustrate how this balance was successfully struck.

\(^{98}\) See \textit{id}. There are issues of mistrust and resent toward the KTA for accreting so much power to itself, as there were toward Congress, who was entrusted to legislate rules for compensating creditors in the Conrail reorganization. There is special concern over real property interests, specifically that the KTA will allow investors to purchase it for a low bid and then turn around and sell it on the open market for higher.

A reorganization plan under Chapter 11 is ideal because it forces an entity to renegotiate with banks and creditors regarding the distribution of assets.\textsuperscript{100} The creditors vote on a proposed plan based on fairness and certain required prioritizations. There are built-in ways to encourage compromise among creditors. If they cannot agree on a plan, a court may enforce the plan, or the court may issue a ‘cramdown,’ which forces creditors to approve the plan or risk losing some value of the claim.\textsuperscript{101} Similarly in a privatization, an agency presides over the parties negotiation of claims, and then uses the entities’ assets to compensate claimants according to the agreed upon plan. In Kosovo, the adjudication function is performed independently by the Special Chamber.\textsuperscript{102}

i. Marshaling Assets while Shielding Investors in Plevic

To illustrate how an entity would strike this balance during privatization, it is necessary to return to the case of Plevic. Since an investor’s dominant motivation in any venture will always be to maximize the return on the enterprise as a whole,\textsuperscript{103} an investor is wary of future claims filed against them or against their property. The reorganization process aims to restore to creditors a portion of the assets of a state-owned entity, while still providing prospects for capital to attract future investors.

\begin{flushright}
\footnotesize
\textsuperscript{100}\textit{Id.}

\textsuperscript{101} Henry H. Perritt, Jr., \textit{Employment Claims in Bankruptcy}, 2012 Employment Law Update Ch. 1 (in press).

\textsuperscript{102} Pauker, at 5.

\textsuperscript{103} Michael J. Gaertner, \textit{Reverse Piercing the Corporate Veil: Should Investors always have it both ways?} 30 Wm. & Mary L. Rev 667, (1989).
\end{flushright}
Finding the proper balance between these two conflicting goals is the fourth and final goal of privatization. Any desire for rapid change must be tempered by the equal and opposite need for properly giving each individual claimant the attention she deserves.

The safest way to ease this tension is to marshal what few assets, if any, an insolvent enterprise such as Plevic holds.\textsuperscript{104} Marshaling of assets requires knowledge of how much the assets listed on the balance sheet of an entity such as Plevic are actually worth. Once valuation is complete, the assets need to be obtained. Once obtained, the governing agency will separate the liabilities from the assets so that investors can purchase the assets free from any complex or uncertain claims against them.\textsuperscript{105} Using the money from bidding, the agency addresses claims in a manner similar to Chapter 11 Reorganization.\textsuperscript{106}

Returning to Plevic, our hypothetical socially-owned enterprise, the agency must take inventory of the assets listed on the balance sheet to see what the real value of these assets is. Equipment and machinery may have depreciated; if that is the case, their value is less than what appears on the asset side of the balance sheet. Contractual obligations owed to the entity, such as the contract with Lybia, and the contract with Yugo may be difficult to enforce and thus more costly than their value reflects. Marshaling these assets may involve chasing down parties who are indebted to the enterprise; in some cases, it may not be possible to obtain the full value of the assets from these contracts. One way to repossess these assets is through coercion. For example, the fact that contractual duties are mutually owed can be used as leverage in obtaining fulfillment

\textsuperscript{104} Arben Limani’s Presentation

\textsuperscript{105} Perritt at 288-89.

of owed obligations. On the other hand, some assets may actually be worth more than they appear, such as real property. Finally, some creditors may be willing to stay their claims until the privatization is complete and the enterprise has actually appreciated. Savvy banks that have loaned money to the enterprise, or current employees who anticipate continuing to work for the enterprise, may be willing to negotiate a new agreement regarding their interests in the enterprise (in hopes of maintaining a share in the business and eventually making more in the long term than they would have in short term damages.)

**ii. The example of Conrail**

A useful model for balancing needs of investors with needs of prior claimants is the case of Conrail in the United States. A series of loosely associated bankrupt railroad carriers were nationalized by the federal government, with the aim of eventually reorganizing them into privately owned companies. The case shows how a money-draining private enterprise, after

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107 In a similar hypothetical case, the creditor is North Korean (DPRK) Government who refuses to honor any contracts now that Kosovo has abandoned socialism. In the this hypo, Plevic has 30k worth of obligations owed to it by the North Korean Government, and the Plevic owes 20k worth of obligations to North Korean Govt. However, the North Korean Government has defaulted on all obligations owed to it now that Kosovo has “defected” to a market-based economy. What can Plevic do to obtain the 10k net asset they are entitled to? First, they have a trustee, such as an agency who is charge of this.

The agency can use the money the contract obligations they owe to DPRK as leverage to get their obligations performed. This is unlikely to work, however, because DPRK is only getting 20k worth of actions, while Plevic is getting 30k, thus there is really no good reason for DPRK to perform (they’re better off not performing). Not only that, but the trustee cannot likely seek performance through courts, because DPRK is not likely to recognize any of those judgments. One idea is to bribe Kim Jong II in DPRK, using 5k, and then netting only 5k. A more moral method for Plevic is to use the leverage of goodwill created by the relational contract with DPRK to reach some agreement, where they don’t get their full 30k paid back, but they get portion of it. Suffice it to say, however, Plevic is not going to get the full value of the contracts with DPRK owed to them.

108 Perritt at 289.

being taken over by the federal government, regulated and re-privatized, was able to turn a profit, \(^{110}\) while still reasonably compensating claimants.

The US freight railroad system was collapsing in the 1970’s due to excessive regulation, expensive labor costs and heavy competition.\(^ {111}\) Facing a termination of the operation of these railways, the government nationalized them under the Regional Railroad Reorganization Act (RRRA).\(^ {112}\) Under this act and other legislation, the railways were consolidated into a new railway system, Conrail.\(^ {113}\) Congress also created The United States Railway Association (USRA) to oversee the consolidation.\(^ {114}\) The new system was incorporated in 1974 and declared millions in losses its first six years.\(^ {115}\)

USRA, like the KTA, was empowered to determine which properties should be preserved for rail transportation, and which should not.\(^ {116}\) Creditors were able to state claims against the railway and seek compensation from the Government for their losses arising out of the transfer of the designated properties.\(^ {117}\) A special was created to hear these cases.\(^ {118}\) Similarly in

\(^{110}\) Dempsey at 566.

\(^{111}\) Id. at 565.

\(^{112}\) Id.

\(^{113}\) Id.

\(^{114}\) Perrit at 289.

\(^{115}\) Id.

\(^{116}\) This is similar to the KTA deciding whether an entity should “sink, or swim.”

\(^{117}\) Id..

privatization, leftover assets of entities are held in trust for parties with claims on those assets, to be adjudicated by a body specially empowered to do so.

In contrast to the post-communist privatization, the Conrail restructuring was supported by a large sum of money and securities, in addition to the limited assets of the enterprises, for claimants to seek awards from.¹¹⁹ Claimants filing actions were compensated with Conrail securities, and a stack of cash set aside under the Tucker Act for such claims.¹²⁰ Fearing that the securities were worthless, the creditors brought 5th Amendment Constitutional Takings Clause claims.¹²¹ They argued the government consolidation constituted a taking without just compensation because the cash award plus the securities would never equal the amount lost by the creditors in the transfer.¹²²

In Blanchette v. Conn. Gen Ins. Corp., the Supreme Court addressed whether an action under the Tucker Act saves the compensation provision under the Rail Act from constitutional deficiency under the takings clause.¹²³ The Supreme Court acknowledged that the compensation under the Tucker Act could indeed be less than the cash value of property taken.¹²⁴ Yet, the Court held that the statutory scheme was sufficient because it was unclear the private owners were entitled to have the full cash value returned to them and because the RRRA was properly

¹¹⁹ See Perritt at 289. The protection under Tucker affords greater security to claimants than those in, for example, the KTA which was characterized by uncertain creditworthiness, uncertain judicial power and a smaller pool of compensatory funds.

¹²⁰ Id.

¹²¹ Blanchette, 419 U.S. at 103.

¹²² See id. at 115-16.

¹²³ Id. at 121.

¹²⁴ Id. at 149-50.
legislated under Congressional power in the bankruptcy clause.\textsuperscript{125} Although the Conrail Cases took place in the United States, under US law, they entail issues similar to those facing creditors in privatizing entities in the rest of the world. The challenges confronting the privatization of isolated industries in the West may be on a lesser scale of magnitude than the privatization of whole industries or nations,\textsuperscript{126} but an agency assigned the task of privatization faces many similar challenges.

\textbf{i. Conclusion}

A nation transitioning away from a socialist economy faces a great many challenges. Nevertheless, recognition of a need for change and the subsequent actions to enact that change brings about prospects of future improvement. In terms of privatization, a stronger, more efficient economy promises greater political stability. Lessons of privatization teach that in order to derive the greatest benefit from the process of privatization, four goals must be met: (1) improved efficiency of economy (2) investor encouragement (3) addressing the needs of parties with valid claims against former socialist entities and (4) maintaining an equitable balance between promoting future investment and addressing prior ownership and creditor claims.

To improve economic efficacy, a state must first be in full support of the decision to privatize. Such a decision requires consideration of alternative plans as well as a hard look at the negative consequences of privatization. Once the need for transition to a market economy is

\textsuperscript{125} Id. at 150.

\textsuperscript{126} Perritt at 289. The Special Chamber, for example, is charged with adjudicating creditor claims during privatization in Kosovo; it has the responsibility of not only overseeing the transfer of assets from public to private in a single enterprise, or even in a single industry, but in an entire nation.
established, the proper means of privatization is the next obstacle, including how an entity should sell off its assets.

An entity trying to sell state assets needs buyers. Private investors, often from foreign countries, are often the most desirable kind of buyer, because they have more money and better business know-how. Encouraging investment requires the cooperation of both the state and the entities undergoing privatization. On the national level, investors will look for a strong business climate and a predictable legal framework because those institutions reduce the risk associated with foreign investment. On a microeconomic level, the investor will look for entities which show some chance of becoming profitable.

Another way to attract investors is to demonstrate to them that parties with valid claims brought against an entity will be heard, and if possible, compensated for their losses. This matters to investors in case they ever find themselves in the position of claimant. Moreover, transition to a liberalized economy requires due process in adjudicating valid property claims because the central tenet of privatization is the importance of respecting private property. Claimants, whether they be lenders, contracting parties, former employees, or landowners like Susette Kelo must at least be given the chance to express their claims in to an independent judicial body or a trusted governing agency. While some of the cloudier theories of ownership may not be accepted, and there may not be enough money to go around, the main point is that the claims are heard and addressed fairly.

The assets of an entity on the brink of bankruptcy are always limited. The fourth and final goal of privatization is to find a way to keep enough assets to attract investors, while setting
aside the rest for compensating valid prior claims. The KTA has been successful at this balancing act, by separating the assets from the liabilities, using the assets to attract investors, and then using investor bids to satisfy costs associated with the liabilities. This process allows the full execution of each privatization goal. It allows economic efficiency to improve via increased competition, encourages investment by erecting a wall between investors and liabilities of the former enterprise, provides a means for adjudicating claims against the former enterprise and maintains a balance between conflicting interests of investor and claimant.